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FM AMEMBASSY BEIJING
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E.O. 12958: N/A

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SUBJECT: China: Bank of Japan Representative discusses Chinese economy

SUMMARY

1. (SBU) On February 4, Finatt Minister Counselor and Econoff exchanged views on the Chinese economy with Kiyoyuki Seguchi, Bank of Japan's (BOJ) Chief Representative in China. Seguchi predicted that China's GDP -- buoyed by growing fixed asset investment and rising domestic consumption -- will likely grow by more than 10 percent in 2008 even as exports slow in the wake of the subprime crisis. He said inflation will remain a top government concern and forecasted and predicted 6 percent average CPI growth rate for the first half of the year. On the renminbi (RMB), Seguchi stated he expects continued gradual appreciation against the U.S. dollar, reaching an optimal point between 5.5 and 6.5 RMB/USD this year, but added that while a 6.5 RMB/USD exchange rate would probably be acceptable to Chinese leaders, a 5.5 RMB/USD rate would be "less palatable." Commenting on the domestic economic impact of the Japanese yen's rapid appreciation against the U.S. dollar in the mid-1980s, Seguchi said policymakers' insistence on maintaining low interest rates well into 1989 -- not the yen's appreciation itself -- caused the development of a "bubble economy."

GDP growth will remain strong in 2008

2. (SBU) Seguchi estimated that despite a possible decline in exports due to the U.S. subprime crisis, China's GDP growth will exceed 10 percent in 2008, although growth could be slightly lower if commodities prices rise sharply. Seguchi noted that between 2005 and 2007, China ran a large trade surplus, which boosted GDP by about two points. Even if the trade surplus narrows due to slower growth in exports to the U.S., Japan, and Europe, China will maintain an approximate 9.4 percent GDP growth in 2008, he argued.

3. (SBU) Seguchi explained that government fixed asset investment (FAI) and rising domestic consumption could make up for slower export growth. He noted that historically, government FAI has risen following changes in provincial and national level leadership. With new provincial administrators in place across the country this year, more public funds will be channeled into infrastructure and development projects. The central government views the development of Western China as a top priority, Seguchi said, and investment in the West and in areas affected by recent snowstorms will likely continue to expand. Seguchi explained that domestic consumption will also increase this year due to job creation, higher wages, and rising farm incomes stemming from higher agricultural prices.

CPI growth will increase at least until mid-year

4. (SBU) Seguchi expects CPI growth to hover around 6 percent until

June before declining throughout the remainder of the year. He noted, however, that this forecast could change quickly and recalled that last year CPI increased rapidly during the summer months -- by 1 percent each month in June, July, and August. Recent snowstorms, he explained, have already caused short-term inflation and may also trigger longer-term inflationary expectations. Such expectations could drive wages upward, in turn fueling further CPI growth.

Renminbi will appreciate gradually

15. (SBU) Seguchi said he encouraged his contacts in the Chinese government to allow the renminbi (RMB) to appreciate gradually against the U.S. dollar following the October 2007 National Party Congress (NPC), noting that rapid appreciation before the NPC would have been politically unfeasible. He acknowledged the possibility that gradual appreciation could lead to currency speculation opportunities and excess foreign currency inflows, but he argued that a big jump in RMB appreciation would be too risky for the Chinese government, as the possible short-term destabilizing effects could run counter to the Hu Administration's "harmonious society" agenda. Seguchi stated that if the RMB appreciates too quickly, exporters could face bankruptcy and domestic farmers would be hurt by a rapid increase in cheaper agricultural imports. Weakened manufacturing and agriculture sectors could pose a threat to the Hu/Wen leadership, he explained.

16. (SBU) In Seguchi's view, the USD/RMB exchange rate should reach an optimal point between 5.5 and 6.5 RMB/USD this year. He explained that while a 6.5 RMB/USD exchange rate would probably be acceptable to Chinese leaders, a 5.5 RMB/USD rate would be "less palatable," as it could hurt exporters and farmers. Seguchi stated that if the RMB/USD exchange rate reaches 6.5 RMB/USD by the end of June and the economy remains stable, the RMB should continue to

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appreciate in order to prevent a build up of excess liquidity, a problem that he considers much larger than inflation or unemployment.

Japan's bubble economy not attributed to yen appreciation

17. (SBU) Seguchi reported that he is often asked by Chinese contacts whether the Japanese yen's rapid appreciation against the U.S. dollar following the 1985 Plaza Accord contributed to Japan's economic woes in the late 1980s and early 1990s. In Seguchi's view, policymakers' stubborn commitment to loose monetary policy, not the yen's appreciation, is to blame. He argued that although the yen's appreciation had an immediate negative effect on exporters, companies producing for Japan's domestic market saw a rapid rise in profits. By 1986, macroeconomic indicators revealed that the economy had already begun to recover from the 1985 appreciation shock. But after years of advocating export-led growth, the Japanese government continued to prop up exporters by keeping interest rates low until 1989. This contributed to asset price inflation well beyond GDP growth rate. Seguchi noted that between 1985 and 1987, real estate prices in Tokyo rose 300 percent; meanwhile, annual real GDP growth over the same period was about 5 to 6 percent.

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